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SUMMARY

¶1. (SBU) Beijing-based economists said this week that moderate inflation likely will continue in 2008, and they expect further administrative tightening measures by the Central Government in order to control prices. Their comments followed the government's announcement earlier this month that China's Consumer Price Index (CPI) inflation increased to a new 11-year high at 6.9 percent year-on-year in November -- a surprise to most observers who had expected inflationary pressures to be easing by now (Refs A and B). A Shanghai-based western economist said he is concerned that high food inflation is now becoming structurally inflationary (see Ref C). The economists agreed that inflation will remain in the 5 - 7 percent range next year and is not likely to go higher, but they acknowledged the danger of global price increases affecting China and they noted the possible impact of higher prices on social stability. END SUMMARY.

CPI STILL SURGING

¶2. (U) China's CPI rose 6.9 percent year-on-year in November, a new 11-year high. Food prices increased 18.2 percent y-on-y with pork up 56 percent and cooking oil up 35 percent. Core CPI (excluding food prices) increased 1.4 percent in November, the highest growth this year. Government announcements and press reports indicated that an oil price increase in November (Ref D) was the major contributor to the non-food price increase during the month.

¶3. (U) Prior to the release of the November inflation figures, the Central Economic Work Conference (an annual economic policy meeting held December 3-5 in Beijing) announced that preventing structural inflation would be the primary task for China's macroeconomic policy in 2008. The Work Conference, and the National Development and Reform Commission (NDRC) Work Conference that followed on December 7, both emphasized the importance of stabilizing prices. NDRC Chairman Ma Kai and Vice Chairman Bi Jingquan focused on stabilizing prices in their public comments.

ECONOMISTS: INFLATION HERE TO STAY

¶4. (SBU) Beijing-based economists expressed surprise that the CPI

increased nearly 7 percent in November and said that the new figure casts doubts on claims previously made by the Central Government and economic analysts that China's inflation problem is likely to be a short-term trend driven by a food supply shock. Rather, the current situation indicates that moderate inflation (5 - 7 percent) likely will continue in 2008. Wang Tongsan, Director of the Institute of Quantitative and Technical Economics at the China Academy of Social Sciences (CASS), who is one of the few analysts who has consistently pointed to underlying structural factors in the economy that could lead to more inflationary pressure (Ref E), said again this week that China is facing a serious inflation problem that will last into 2008, particularly because price surges -- both in China and internationally -- in the latter half of 2007 will have a lagging impact on next year's CPI. Sun Bulei, an economist at the Stock Exchange Executive Council (SEEC), said he would have expected the CPI to be decreasing by now rather than increasing from 6.5 percent y-on-y in October to 6.9 percent in November.

¶5. (SBU) Our contacts agreed that the Central Government will need to implement additional administrative tightening measures in order to control prices. Those measures are late in coming, said Wang Boming, President of the SEEC. He stated that the Central Government should have introduced tightening measures in the summer but government officials failed to agree on the best course of action because of disagreement on the root cause of the inflation. Even if they were to agree, Wang said, policymakers have few tools to counter inflation and are virtually powerless to rein in local governments, which are not interested in slowing investment.

¶6. (SBU) Wang Tongsan at CASS agreed, stating that on both fiscal policy and monetary policy, the government's hands are tied. The government should pursue a more prudent fiscal policy with slower growth in fixed asset investment, he said, but there is a conflict

because the government also wants to promote development in western China and rural areas by providing budgetary support. In addition, provincial officials in other parts of the country (ex. Central China) want to continue to attract investment and boost GDP growth. The government could tighten its monetary policy by speeding up the pace of exchange rate appreciation and/or raising interest rates but is reluctant to do either because China benefits from the undervalued exchange rate and does not want the interest rate gap with the United States to grow.

NOT JUST ABOUT FOOD PRICES ANYMORE

¶7. (SBU) Stephen Green, the Senior Economist at Standard Chartered in Shanghai, maintained his position that higher food prices are hurting average consumers (Ref C) and added that the cumulative effect of high food prices over the past six months is now creating a structurally inflationary situation. The oft-heard government argument that inflation is not a significant problem because core inflation remains low is no longer a valid position, Green said, as a high-inflation environment that persists for 6 - 12 months is one that is structurally inflationary and will affect non-food sectors. Wang Boming agreed that the focus on food prices to date has been misleading because it has ignored other causes of higher prices (fast GDP growth, higher international prices, excess liquidity in the money supply, etc.), and the government will have to address those problems in 2008.

THE IMPACT OF GLOBAL PRICES

¶8. (SBU) Contacts uniformly agreed that higher global prices for energy (oil) and food (grains) will affect prices in China in 2008. Some also said they are concerned about the possible impact on China of higher inflation in the United States. (Note: Econoff delivered Ref F talking points to those interested in the financial situation in the United States. End Note.) Wang Tongsan at CASS said that he believes higher international prices will lead directly to higher domestic inflation in China in the coming year.

SOCIAL STABILITY CONCERNS STILL PARAMOUNT

¶9. (SBU) Economists also stated that the government's efforts to address inflation are primarily due to continued concerns about the impact of rising prices on social stability. Wang Boming said that the government is in a difficult position because it wants to encourage fast GDP growth (9.5 to 10.5 percent) to maintain social stability, but GDP growth in 2007 (which is likely to exceed 11.5 percent) has been too fast, thereby fueling inflation. Indicating the level of concern about inflation at the local government level, a December 12 Reuters report stated that a recent survey of 154 officials studying at the Communist Party's Central Party School showed that 30.5 percent of officials believe inflation is China's most pressing social problem followed by income inequality at 23.4 percent.

COMMENT: A TURNING POINT?

¶10. (SBU) It appears that moderate inflation will continue in early 2008, but there are no indications yet that inflation will reach dangerous levels of 10 percent or higher. Nevertheless, the government is concerned about on-going 5 - 7 percent inflation and wants to control prices in an effort to ensure social stability. We are likely to see more subsidies for food and energy for low-income groups. Our discussion with local economists suggest that this may be a turning point for policymakers in their perception of inflation, as there now are few who believe short-term food inflation is the only factor leading to price increases. Inflation will continue in 2008, and government officials and economic analysts now appear to recognize that the Central Government needs to address price increases not only as a short-term food supply shock but as a long-term structural issue. The government's ability to address inflation through market mechanisms or administrative controls, however, remains limited.

RANDT